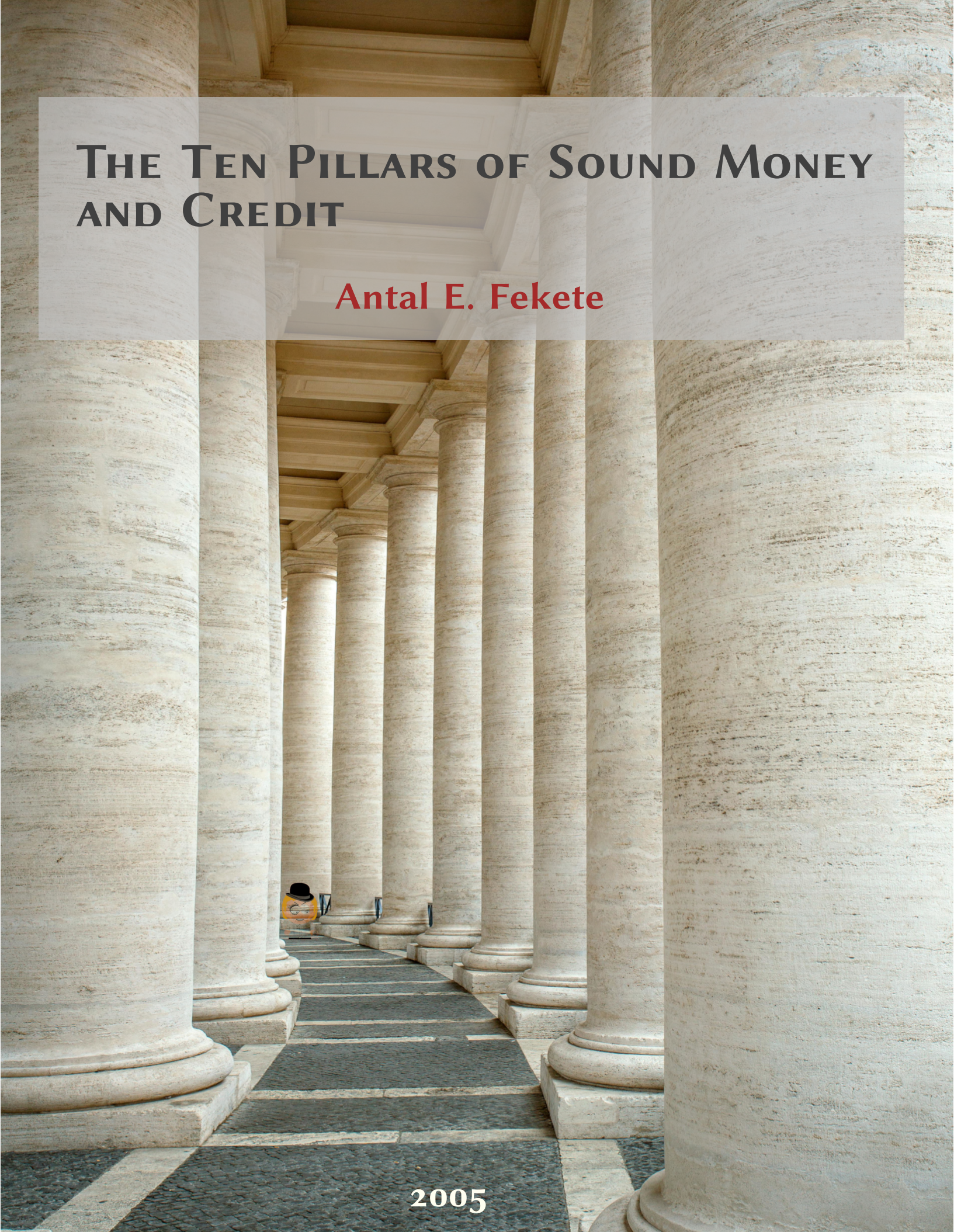




THE TEN PILLARS OF SOUND MONEY AND CREDIT

Antal E. Fekete

2005

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Contents

Contents

1	The First Pillar of Sound Money and Credit	
	The Principle of the Gold Standard	5
2	The Second Pillar of Sound Money and Credit	
	The Principle of Free Coinage	11
3	The Third Pillar of Sound Money and Credit	
	The Principle of Redeemability	15
4	The Fourth Pillar of Sound Money and Credit	
	The Principle of Monetary Policy	21
5	The Fifth Pillar of Sound Money and Credit	
	The Principle of Fiscal Policy	25
6	The Sixth Pillar of Sound Money and Credit	
	The Principle of No Privileges Without Responsibilities . .	31
7	The Seventh Pillar of Sound Money and Credit	
	The Principle of Liquidity	37
8	The Eighth Pillar of Sound Money and Credit	
	The Principle of Matching Maturities	43

Contents

9	The Ninth Pillar of Sound Money and Credit	
	The Principle of Productivity of Debt	47
10	The Tenth Pillar of Sound Money and Credit	
	The Principle of Productivity of Labor and Capital	53

Foreword

The Ten Pillars of Sound Money and Credit forms part of the downloadable content found in the ‘Money and Credit’ section of Professor Fekete’s website¹. It is a compilation of ten files, seemingly written in year 1985 and edited for academic purposes during September 2005, one file for each “pillar.” Therefore, the publication is structured as a ten-chapter textbook. Consisting of short chapters, the work explains ideas and concepts in a simple and clever way to introduce readers, regardless of their familiarity with the subject, to each argument, while providing a general view of Professor Fekete’s conception of *Money* and *Credit*.

The contents are based entirely on open-access material from the website. This is a free publication, and no commercial use is intended.

¹www.professorfekete.com

Chapter 1

The First Pillar of Sound Money and Credit

The Principle of the Gold Standard

A Chinese Tale

Once upon a time the standard of measuring length, the foot, was defined in China as the length of the foot of the emperor. A change of the standard occurred upon the death of the old emperor, as a proclamation heralding the length of the foot of the new emperor was made. Later emperors discovered to their delight that they did not have to die in order to bring about a change of the standard. Imperial pleasure could proclaim a change in imperial footage at any time.

The ropemakers of the Celestial Empire learned to live with this capricious and whimsical system. They withheld production when they suspected that a shrinkage of the imperial foot was imminent. One day the ropemakers became even smarter. They formed a lobby in the Celestial Court, to persuade the Son of Heaven to have his toes amputated in order to make the imperial foot even shorter. This was thought to have a salutary effect on the ropemaking business. When, however, the people of the Celestial Empire found out what was afoot at their expense, they rose in anger, beheaded the emperor, and made the new emperor declare the length of a platinum rod as the official standard.

It was thought that platinum was impervious to changes inspired by minority pressure groups.

How to Replenish Water in New York City's Water Reservoir

The basic characteristic of any good standard of measurement is that of fixity. And a nation has no standard of measurement more important than its standard monetary unit, because its money reaches and affects virtually every activity of all its people in domestic commerce as well as in foreign trade.

Changing the standard of value, or the devaluation of a currency is like the amputation of one's arm or leg: it is a great misfortune. Informed people do not engage in either sort of amputation unless it is unavoidable. We pride ourselves on being infinitely more scientific than the Celestial Empire of old, as we define the unit of length in terms of the wavelength of the orange color in the light spectrum. Nowadays, we respect such standards of measurement as the foot, the pound, the gallon, etc.

For example, if the water supply of New York City is depleted, say by one-half, Congress could conceivably change the definition of the gallon to one-half of the original as the easiest way to restore the number of gallons in the reservoir and forestall panic among city dwellers. But Congress knows that such tampering would be unscientific. Changing the definition of the gallon would do nothing to restore the original amount of water in the reservoir, while it would cause havoc at the gas pump. Congress knows that people would see through the mischief and would react unfavorably to the farce.

When Best Is Worst, and Worst Is Best

When it comes to the standard of monetary value, which also serves as the standard of deferred payments such as pensions and life insurance, a

peculiar confusion and inconsistency reveals itself. As national profligacy depletes the reservoir of wealth in the country the Congress has found it expedient to resort to tampering with the standard measuring the quantity of wealth in the nation. Congress reduced the value of the monetary standard, the dollar, in order to conceal the alarming news from its constituents. And in 1971, Congress abolished the standard altogether, when it abdicated its Constitutional responsibility by allowing the dollar to float. Today the length of the foot of the incumbent Chairman of the Federal Reserve Board is the effective standard, and it is up to him and his colleagues on the Open Market Committee to say what this length is. The amazing thing is that we accept the alteration of the definition of the dollar when the things it is supposed to measure do not conform to their wishful thinking, although we would not accept the alteration of the definition of the gallon motivated by the same considerations. The explanation of this irrationality cannot apparently be compressed sufficiently for inclusion here. As though struck with a fever or some sort of madness, government officials and powerful groups of industrial and agricultural leaders took the position that a country with weak currency has an advantage over a country with a strong one, and that it is necessary to pull the strong currency down to the level of the weak. The worst currency is really the best, and the best currency really the worst.

Squandering the Wealth

In our wild embracing of this madness, we never settled down to state clearly just what is the target of currency depreciation or “goodness” in money. The secret of that mystery is ostensibly in the hand of the currency manipulators who perform as though they had a hotline to Heaven. They never can bring themselves to face the logic of their basic position that, if a depreciated currency is better for our country than one based on a fixed monetary standard, the best currency would be the one having no value at all, and that country would gain most which simply gave away its goods

and services. The extent to which the nation, and particularly its leaders in Washington, are afflicted by this phantasmagoria that we can maintain prosperity and increase our standard of living by giving away wealth should be apparent from the September 22, 1985 announcement¹ of the plot by the Group of Five industrial nations to beat down the value of the dollar.

The Proper Monetary Standard

The typical currency system has various kinds of moneys in circulation, and it is the proper function of the monetary standard to keep the value of each unit of each kind of money equal to that of each unit of every other kind of money in the system. A standard monetary unit should be something which itself has value. It cannot be an abstraction, a legal fiction. It cannot be a promise to pay let alone an irredeemable promise. It must be material property commanding the most universal acceptability. To serve its purpose best, it should have a relatively high value in small bulk; it must be permanent, resistant to tarnish; it must be homogeneous, divisible without loss of value; and it must be readily recognizable. For these reasons gold has evolved, over thousands of years, as the material of which the monetary standard is made.

Fate of a Government Prophecy

The value of gold is not derived from its monetary applications. Back in 1967 government economists prophesied that if the U.S. Treasury stopped bidding for gold the dollar price of gold would drop, perhaps by as much as 50%. On March 15, 1968, the U.S. Treasury and the cartel of central

¹N.B.: On September 22, 1985, the "Group of Five" (G5) nations - the US, Japan, West Germany, France, and the UK - signed the Plaza Accord at the Plaza Hotel in NYC. The agreement aimed to depreciate the US dollar against the Japanese yen and German Deutsche Mark to correct massive US trade imbalances.

banks known as the Gold Pool withdrew their long-standing offer to buy unlimited quantities of gold - and the rest is history. Refusing to fall, the dollar price of gold started rising immediately and has followed a checkered path upwards ever since. The government economists were wrong. The monetary economists who maintained that a dollar is a promise to pay a fixed amount of gold on demand, and that the repudiation of that promise cannot enhance the dollar's value, were right. Since March 15, 1968, the dollar has lost almost 90% of its gold value - and a commensurate amount of its purchasing power.

Marginal Utility of Gold

The most important quality of gold as monetary metal is its universal acceptability. In technical economic language, the marginal utility of gold is constant in contrast with that of any other good, all of which have more or less declining marginal utilities. In other words, the acceptability of gold in exchange for goods and service does not depend on the amount of gold possessed by the parties to the exchange.

The recent collapse of the price of oil and tin² shows the rapidly declining marginal utility of these resources. Unlike gold, the acceptability of oil and tin depends on the amount in the possession of the market participants: the more they have, the less acceptable these resources become. Gold is the only commodity that can be offered in unlimited quantities in exchange for goods and services across all national boundaries. Without apparently harming its exchange value. Moreover, gold is the only asset that individuals and governments will carry in the balance sheet without any promise of return to capital. Gold is the only asset that can balance a liability without being at the same time a liability of someone else. It is the only financial asset that can survive the consolidation of the balance sheets of any combination of individuals or governments.

²1985.

Most Abundant Commodity On Earth

Economics accounts for this anomalous behavior of gold not by appealing to psychology or to human weaknesses such as vanity or superstition, but by appealing to logic. Even if we regard the choice of gold as monetary standard as an historical accident, by now gold is so firmly entrenched that its replacement is virtually unthinkable. Almost all the gold that has been produced since the dawn of history is still available in marketable form. The same simply cannot be said of other commodities. They all disappear in consumption. The ratio of stocks of gold to annual production flows is a high multiple, estimated to be between 80 and 100. For other goods, the ratio of stocks to flows is a small fraction, e.g., 1:3 for copper. The latter is an interesting example because copper, like gold, also has a long and rich history including its history of monetary applications. Yet, if copper stocks were to double overnight, raising the stock/flow ratio to 2:3, then the price of copper would collapse and all but the most efficient producers of copper would be ruined. No matter how many marginal applications for copper we may find, the marginal utility of copper would be testing zero - e.g., copper would be a “free” good, like drinking water. By contrast, if the stock/flow ratio of gold went from 100 to 200, hardly anybody would take notice. Gold producers would continue to prosper. The increase in the ratio would be looked upon as another confirmation of the supreme confidence individuals have in gold as a store of value.

In these terms, gold is the *most abundant* commodity known to and produced by man. Gold does not owe its value to its alleged scarcity. On the contrary, gold owes its value to the fact that, in spite of its abundance and steady increase of abundance, gold continues to be in universal demand, and it continues to be acceptable in unlimited quantities. No other asset can match the record of gold in this regard. No other commodity can withstand the wear and tear the monetary standard is constantly exposed to.

Like the Chinese platinum foot, gold may not be a perfect standard, but it is the *only conceivable monetary standard we have*.

Chapter 2

The Second Pillar of Sound Money and Credit

The Principle of Free Coinage

A Chinese Tale

Once upon a time money in China consisted of silver coinage issued by the Imperial Treasury. Since time immemorial, the main source of imperial revenue has been seigniorage, due to the limit the emperor placed on the number of silver coins in circulation. Consequently the Imperial Treasury could buy two pounds of silver from the people in exchange for coins containing only one pound, then turn around and mint it into twice as many silver coins. The difference was simply expropriated by the emperor. As a result of this cruel exploitation, people of the Celestial Empire fell into the direst poverty. Money was exceedingly scarce. Parents were selling their children into slavery, and they killed their baby daughters when no takers were found.

The chief mandarin, Kwang, threw himself at the feet of the emperor, pleading thus: "Son of Heavens, have pity. People are suffering. Money is scarce."

The emperor made an edict providing for free coinage. From then on, people could take all the silver to the Treasury and get the same weight in silver coins in exchange. Seigniorage was abolished. There was a great relief all over the Celestial Empire. A tremendous resurgence of agriculture and industry took hold. The humblest of coolies could pick and choose between jobs. People were

becoming so prosperous that husbands started to embellish their wives with choice silver jewelry. Hardly twelve moons had passed when Kwang threw himself at the feet of the emperor once more and pleaded thus: "Sire, money is still scarce. The people want you to issue paper money in order to augment the circulation of silver coins."

The emperor, who was a wise man, answered: "Kwang, you are talking like a fool. You ask me to restore poverty that I abolished in this country twelve moons ago. I have given people the right to put their silver where their mouth is. If money is still scarce, they have only themselves to blame. Let them bring their jewelry to the Treasury, and we shall give them silver coins, pound for pound. If they really think that money is scarce, they have to prove it not by words, but by deeds. Remember, Kwang, it is not the abundance of money that makes people prosperous, but the unencumbered fruits of their own effort. By the same token, it is not the scarcity of money that impoverishes them, but exploitation that you now try to advocate."

And Kwang went off, tearing his beard, as he lamented: "Oh Wo! Oh Fu! Oh Pe! Oh Li! And all the two-letter named gods of Cathay! Take pity on our people! For there has come to us an emperor of the Austrian School, who believes that people can lift themselves out of their misery by their own bootstraps! The emperor is deluded by the idea that wealth is created by the coolies! He no longer believes that the source of all wealth lies in the power to regulate the money supply."

Beat Scarcity

There will always be people who complain that money is scarce. Today, there is no answer to these complaints. In a true sense of the word, everything of value is scarce. The only way to abolish the scarcity of the dollar is to make it lose all its remaining value. And there is a real danger that this is exactly what we are doing.

Money and money-substitutes have never been so abundant as they are today in the United States. Yet, if we are to believe the officers of Continental

Illinois, and the directors of the savings banks in Ohio and Maryland, money is excruciatingly scarce in this country.

The only way to stop the vicious agitation against the scarcity of money is to put the power of issue where it belongs, namely into the hands of the people. This means free coinage of gold. When this is done, every citizen who believes that there is too little money in circulation can do something about it. He can take his old jewelry or his newly mined gold to the U.S. Mint, and convert it into the gold coins of the realm. After this fundamental right - guaranteed by the Constitution but abolished in 1933 - has been restored to the people, all cries about the scarcity of money can be exposed as frivolous gibberish.

Latter-day Slaves

The principle of free coinage also exposes the cruel exploitation to which the people of the United States have been subjected by the mandarins in the Treasury and on the Federal Reserve Board. The Constitution abolished bondage embodied by seigniorage in this country, but the bureaucrats have reimposed a more cruel seigniorage through the back door.

The rate of exploitation in the Celestial Empire of old was 2:1, as silver in the hand of the emperor was worth twice as much purchasing power as the same silver in the hands of the people. Today the rate of extortion in the United States is 35:1. As reported in The New York Times on July 21, 1985, Michael Brown, a spokesman for the United States Mint in Washington D.C. explained that the Susan B. Anthony dollar, introduced in 1979, costs 3 cents each to make, allowing the government to pocket a profit of 97 cents. Thus resources in the hands of the Treasury can create 33 times more purchasing power than the same resources in the hands of the people. The extra purchasing power is not created out of thin air: it is simply extorted from the people.

Mr. Brown used these figures to support his argument against melting down half a billion Anthony dollars which nobody seems to want. If the

coins were melted down for the metal, the government would have to take a loss. “And we don’t want to add half a billion dollars to the deficit,” Mr. Brown was quoted as saying.

The rate of exploitation in the United States would be much higher if the calculation was based on the cost of printing bonds, which the Treasury can turn into cash at the Federal Reserve banks.

Moloch of Managed Money

Irredeemable currency could be made to work in a free country only if every citizen were given the right to print and to dispose of his bonds on the same terms as the Treasury. But this would make the bonds and ultimately the dollar lose their remaining value. Therefore the regime of irredeemable currency can never be made to work, nor can it be made compatible with freedom.

The usurpation of the Constitutional right of the people to free coinage, and the reimposition of bondage embodied by the seigniorage, makes free citizens into slaves of the government. Moreover, the unemployed are like the innocent female infants in China, earmarked to be sacrificed on the altar of the Moloch of Managed Money.

Chapter 3

The Third Pillar of Sound Money and Credit

The Principle of Redeemability

A Chinese Tale

Once upon a time a revolution of lasting import took place in China: the invention of paper and the simultaneous invention of paper money. Silk products had long been used as the material on which documents and contracts could be written. The revolutionary character of paper was to be seen in the fact that it was a thousand times cheaper than silk, and it could still carry the same message just as efficiently.

The most potent message that paper was capable of carrying was the promise of the Imperial Treasury to pay the bearer a stated sum of silver coins on demand. The Treasurer, Ding, discovered that he could pay the suppliers of goods and services to the Celestial Court with such paper promises. People trusted the Treasury and accepted its promise to pay as equivalent to payment in silver coin.

Soon afterwards the Treasury ran out of free silver, as it found that all the silver coins in its coffers had been mortgaged in the form of outstanding promises. Ding refused to issue more paper money except in exchange for silver coins paid into the Treasury. In his view any other course of action would compromise not only the integrity of the promises of the Treasury but also that

of all the contracts in the Celestial Empire, affecting a value far greater than the value of paper money in circulation. Contracts made by third parties in good faith would be rendered impossible of fulfillment and the standard, or measuring rod, of honest dealings among the populace would be destroyed. A decline in prosperity would follow in due course, as the cornerstone of economic well-being is the integrity of promises men live by.

But the Deputy Treasurer, Dong, was an ambitious man and he saw that Ding had painted himself into a corner. Dong threw himself at the feet of the Emperor, pleading thus: "Sire! Let me issue further promises to pay silver coins against the cutlery, candelabra, and other silverware of the Celestial Court!" The Emperor promptly fired Ding, and rewarded Dong for his resourcefulness by making him Treasurer.

Dong could not enjoy his newly found glory and power long. Other ambitious men in the Court took careful note of what happened at the Treasury. They got the ear of the Emperor in suggesting that even more paper money could be issued against silver that had not yet been brought out of the imperial mines, as well as against the silver in the Moon. Because the Moon was considered a province of the Celestial Empire, and it was thought to consist of silver 95% pure, a belief confirmed by a recent scientific study released by the Heavenly Research Council, there was a plausible case for expanding the issue of paper money. The Emperor fired Dong, and thereafter the change of the guard at the Treasury became a frequent ritual, each time a more unscrupulous adventurer succeeding a less unscrupulous one. The promises of the Treasury to pay silver coins on demand had lost all their remaining value.

In the aftermath of the depreciation of paper money a Great Cultural Revolution engulfed the Celestial Empire. People took to the streets, purged the Heavenly Research Council, and hanged all the past Treasurers on makeshift gallows erected along the Square of Heavenly Peace, stuffing their mouths with the paper promises that they had signed.

Not Worth a Continental

The United States, in its infancy, attempted the same process by the issuance of Continental currency. This currency collapsed in the same way as its ancestor in China. Later, one of the greatest orators of all times, Daniel Webster, denounced irredeemable paper money on the floor of Congress in 1832¹ in these words: “Of all the contrivances for cheating the laboring classes of mankind none have been more effectual than that which deludes them with paper money. Ordinary tyranny oppression, excessive taxation ... these bear lightly on the happiness of the mass of the community compared with fraudulent currencies and the robberies committed by depreciated paper.” Today we reject the dictum of Daniel Webster, and indulge in the same national sin which promises to exact, some day, severe penalties for our belief that we can challenge with impunity such fundamental truths as those involved in the maintenance of standards of common honesty in the fulfillment of our promises.

The Ballot Box Is Not Enough

The principle of redeemability of the currency asserts that, if a citizen believes that there is too much money in circulation, he must have the right to do something about it. He should be allowed to hoard, melt, or export the gold coins in his possession, thereby redeeming the commodity value of the monetary standard. It also asserts that the citizen should be allowed to withdraw the gold reserves which form the basis of the monetary system, to the extent of his holdings of paper money or bank deposits. When a currency is redeemable in standard gold coins, any individual disturbed by the behavior of the government or banks can attempt to protect himself by presenting for redemption such paper currency as he may command. It is this power of individuals that holds, or tends to hold, banks and government

¹N.B.: Daniel Webster, “Robberies” by Paper: In a speech on the currency in the Senate (often cited around 1832 or during the 1837 bank crisis).

in check. Without this power the people, as individuals, are helpless insofar as control over their banks and government is concerned. The power of the ballot box provides no protection, after the government has freed itself from the obligation to redeem its promissory notes, and acquired power to expand the volume of paper money without fear of adverse public reaction. The way to government dictatorship has been opened up. Human freedom has been endangered. The variety of ways in which freedom could be impaired or destroyed is practically countless as the government takes more and more power from the people and to itself. Limited government is not possible unless the principle of redeemability of the currency is respected.

A Nursery of Tyranny, Corruption and Delusion

In his classic monograph *Fiat Money Inflation in France*, the distinguished scholar Andrew D. White², joint founder and first president of Cornell University, quoted Mirabeau of France as saying in 1789 that irredeemable currency is “a nursery of tyranny corruption and delusion: a veritable debauch of authority in delirium.” His contemporaries ignored the admonition, issued the assignats and the mandats³ - and history has attested the accuracy of Mirabeau’s prophecy.

The act of inflicting an irredeemable currency on a people is an act of dishonesty by the government, and the influence of that dishonesty spreads through an endless number of channels and in an endless number of forms to the mass of people who are then corrupted in countless ways. To use White’s words: such corruption grows “as naturally as fungus on a muck heap. It was first felt in business operations, but soon began to be seen in the legislative body and in journalism.” As to the corruption among legislators, he stated that “there was enough to cause widespread distrust, cynicism and

²N.B.: Andrew D. White, *Fiat Money Inflation in France, How it came, what it brought and how it ended* (New York: D. Appleton & Co., 1896).

³N.B.: Assignats and mandats territoriaux (land warrants) were two distinct, successive forms of paper money issued during the French Revolution (1789-1797) to combat financial bankruptcy, which ultimately resulted in severe hyperinflation.

want of faith in any patriotism or any virtue. Worse still was the breakdown of morals of the country at large, resulting from the sudden building up of ostentatious wealth and from the gambling, speculative spirit, spreading from large towns to small, and to rural districts. The disgraceful result was the decay of national good faith.” White stated that “there came cheaterly in the nation at large and corruption among officials and persons holding public trusts ... Faith in moral considerations, or even in good impulses, yielded to general distrust. National honor was thought a fiction cherished by hypocrites. Patriotism was eaten out by cynicism.”

“It ended in the complete financial, moral and political prostration of France - a prostration from which only a Napoleon could raise it.”

White concluded, in his *Fiat Money Inflation in France*, that “every other attempt of the same kind in human history under whatever circumstances, has reached similar results in kind if not in degree.”

No doubt the authors of the assignat and mandat thought that they were acting on firmer scientific basis than the Treasurers of the Celestial Empire. Yet, from the perspective of the 20th⁴ century observer, the only breakthrough was the replacement of the gallows by the more efficient guillotine.

⁴1985

Chapter 4

The Fourth Pillar of Sound Money and Credit

The Principle of Monetary Policy

A Chinese Tale

Once upon a time the Treasury of the Celestial Empire was found empty. The Emperor instructed Hwa, the Chairman of the Heavenly Research Council, to work out a plan to meet the emergency.

Hwa suggested that the Emperor assume the title “The Son of Heaven,” thereby laying claim to supernatural powers. The Emperor would then inject words and phrases such as “targeting the money supply,” “clean versus dirty floating,” “the crawling peg,” “semi-fixed standard,” “snake in the tunnel,” “softening the bands of hard currencies,” and so forth, into the public debate on money, thereby endowing these meaningless words with sacramental effects. The purpose of this exercise would be to induce men to give up actual goods and services in exchange for fictitious ones.

The Emperor went along with these proposals and debased the silver coins of the Empire, while retaining the coins’ outward appearance. But the people refused to be duped, and they accepted the debased coins only at a discount. Hwa threw himself at the feet of the Emperor. “Son of Heaven, it is not enough for you to claim absolute power over the value of coins and over the destiny of the people. You must also forbid any examination of your claims. You must

outlaw logic. All questions about currency depreciation must be tabooed. To ask them, to answer them, even to think of them must be declared an act of sacrilege, an unpardonable sin. Only then will people believe that coin-clipping is no self-mutilation, but rather the mutilation of their competitors. Only then will the coolie stop cursing and start blessing his yoke."

The Emperor was not impressed. "Hwa, you talk like a fool. Even a child can see through your theocratic fraud. All he need ask is whether the priest is the instrument of religion, or religion is the instrument of the priest. The proof that the people have been duped is that the priest is rich and powerful. He can taboo questions, he can adjust moral principles to suit himself. So your studied gestures and poses, your hieroglyphic messages are losing their effects because people observe your simony, the trafficking of relics. Seek as one may, there is no substitute for an informed and enlightened public opinion. It is the only remedy."

Then the Emperor recalled the debased coinage, and let it be known that hard times can be overcome if everybody worked, and saved, even harder. Before twelve moons had passed, the Treasury was once more replete with full-bodied silver coins.

The Biggest Human Exploitation

Today people take it for granted that "targeting the money supply" is a legitimate objective of monetary policy. It wasn't always like that. In 1932, the Canadian economist and humorist, Stephen Leacock, could joke:

"Now I say this in all sincerity that the three-men-in-a-room stuff will do for the Soviets; it will not do for us. You cannot have a system of social controls dependent upon the will of three men in a room. You cannot have prices which can be moved up by a group in control. You cannot have wages which can be shifted down in their purchasing power by the good will of the men of the monetary caste. You must weigh that very very carefully. The board, when it boosts prices up or down, would follow or be tempted to follow, all sorts of self-seeking

ends. You cannot run society like that. If you try to have a money standard based on human interest or opinion, you have started the biggest human exploitations one can possibly imagine.”

The Greatest Virtue of the Gold Standard

The concept of the money supply is a spurious one, and the idea of targeting the money supply by open market operations of the Fed is a modern theocratic fraud, establishing the biggest scheme of human exploitation in history. The extent to which this method of plunder is practiced is in inverse proportion to the perspicacity of the people. It is in the nature of abuses to go as far as they can. Plunderers conform to the Malthusian law: they multiply in direct proportion with the means of existence - and the means of existence for knaves is the credulity of their dupes.

If God had made man a solitary animal, everyone would labor for himself, and individual wealth would be in proportion to the services that each man performed for himself. But since man is a social creature, services are exchanged for services. Moreover, to provide for certain needs such as security the members of society organize governments and agree to tax themselves in order to cover these needs. The government too is subject to the Malthusian law. It tends to expand in proportion to its means of existence which, in the last analysis, is nothing but the substance of the people. So when the government runs out of real services, it will continue to expand by offering fictitious services to the taxpayer. Targeting the money supply is one of the most reprehensible of these fictitious services.

In private transactions each party remains the sole judge of both values: the value of services rendered, and that of services received. The individual is perfectly free either to decline the exchange or to make it elsewhere. The greatest virtue of the gold standard is that the medium through which these services are exchanged is left outside of the political arena, and hence individual valuations remain as free of distortion as possible. But when government starts targeting the money supply it interposes between the

The Fourth Pillar of Sound Money and Credit

exchanging parties a medium which cannot be valued because it has, by design, no definable value. In combination with that fatal disposition, that one man could always be persuaded to live at the expense of others, this interposition by the government creates enormous disparities between the exchanging parties, while plundering both. The people are astonished to find that, while they hear of wonderful inventions that are supposed to save labor and multiply output without end, they are working as hard as ever and are still no better off than before. Meanwhile, things go from bad to worse and, at last, people open their eyes, not to remedy (for they have not yet progressed that far), but to the evil.

Monetary Policy Under Limited Government

Targeting the money supply is an arbitrary and unlimited power, which is at variance with our Constitution and with the principles on which our government is based. Constitutionally, the government has a carefully circumscribed responsibility in the realm of money. This is to see to it that the value of every kind of money in circulation, namely coins, bank notes, bank drafts, bank deposits, etc., rigidly conforms to the standard unit of value. The government is charged with the responsibility of stabilizing the value of currency and it must not aggrandize its powers by destabilizing it.

Chapter 5

The Fifth Pillar of Sound Money and Credit

The Principle of Fiscal Policy

A Chinese Tale

Once upon a time there were, in China, two great cities: Chin and Chan. They were connected by a magnificent canal. One day the Emperor sent for his chief mandarin, Ching, and said: "Look yonder." Ching opened his eyes and looked. And he saw scores of barges laden with cargo, plying between the ports of Chin and Chan. The Emperor then commanded: "We must stop that traffic, in order to increase employment in the Celestial Empire. You will have huge blocks of stone thrown into the canal to put it out of service." At first Ching did not see the point and said: "Son of Heaven, you are making a mistake." However, the Emperor's mind was made up, and he said: "Ching, do as you are bid. We are going to stimulate the economy. You come back after three moons have passed, and take another look."

When he came back, the Emperor said: "Look yonder." As he looked, Ching saw thousands of carts and innumerable pedestrians carrying heavy burdens on their shoulders, as they were making their way from Chin to Chan, and from Chan to Chin. They looked like a swarm of migrating ants. The Emperor declared: "It was the destruction of the canal that provided jobs for these poor people. We shall make it public policy to stimulate the economy by all available

means.” Ching remarked in admiration: “I should have never thought that the government could create so many jobs so quickly and so easily.”

When the Emperor died, his successor sent for Ching and ordered him to have the canal reopened. Ching prostrated himself nine times and said to the new Emperor: “Son of Heaven, you are making a mistake.” But the Emperor was adamant: “Do as you are bid. We must facilitate the movement of people and goods between Chin and Chan, by making transportation less expensive. Then the people may have rice, tea, and silk at a lower cost.” Ching thought he was ready with the answer: “But what is the use of lower prices, if no one can pay them, because everyone is unemployed?” The Emperor was losing his patience: “Ching, you are talking like a fool. Come back after three moons have passed, and take another look.”

When Ching came back, the Emperor said: “Look yonder.” Ching looked and saw more traffic in the canal than anybody had ever seen before. The barges were moving day and night, bumper to bumper, there was no hint of unemployment. The Emperor dismissed Ching with these words: “You can divert and displace labor, but you can never create new employment by erecting obstacles. Remember the wisdom of the old sages, that the secret of good government is to leave people alone.”

Quality of Credit

The sole aim of fiscal policy is to keep the credit of the government at the highest possible level and above all suspicion. This principle implies that the government borrows only if it can see the revenues which, in the years coming, will be available to retire the debt. If this principle is respected, then the rate of interest will be stable, and it will be the lowest possible rate consistent with economic conditions. Otherwise, the rate of interest will be higher and unstable. Moreover, the rise and instability will be commensurate with the extent to which this principle has been compromised. This will make it difficult for some and impossible for other private producers of wealth, to reinforce their enterprise by borrowing.

The quality of credit in a country cannot be higher than that of the government. Therefore, the deterioration of the government's credit adversely affects every single producer in the country.

The canal carrying the trade between Chin and Chan symbolizes a national economy that respects the principle of fiscal policy. By deviating from this principle, the government puts the canal out of service. The blocks of stone symbolize the higher rate of interest which private producers of wealth pay after all the borrowing needs of the government are satisfied. This would not stifle the national economy but would certainly render it more inefficient. A dilution of the principle of fiscal policy is usually couched in a language which would appeal to those susceptible to demagoguery. Deficit spending is called "priming the pump," "an essential stimulus to the economy," indispensable to the maintenance of full employment. Yet it is clear that the stimulus of deficit spending is at best dubious in the short run, and completely absent in the long run. The short-term effects have the nature of prestidigitation, as government spending can be targeted to pockets of slow economic activity in order to produce spectacular results. It is the long-run effects where the damage to the economy becomes visible.

Accumulation of Public Debt versus Accumulation of Capital

The accumulation of public debt is a convenient trick through which a temporary semblance of prosperity may be achieved. In the long run, however, this policy will only aggravate the situation, as it harms the economy by weakening productive capacity. The longer the government succeeds in maintaining false prosperity by increasing public debt, the greater the ultimate damage.

Mainstream economists ridicule this concern about the negative effects of the rising public debt on future economic growth. There is no way - so the argument goes - to shift the economic burden to future generations. You can only consume what has been produced. Under these circumstances, how can a nation live beyond its means? This argument is designed to

appeal to simpletons. The basis for all economic growth, rising real per capita income, increased production and consumption, is the result of entrepreneurs investing their own and other people's funds in more and better tools, which permits a steady increase in man-hour productivity. Economic growth, and a rising standard of living, are ultimately dependent upon uninhibited capital accumulation.

Capital accumulation, however, is not an automatic process regulated by mother nature. To produce capital goods - factories and machinery - a corresponding amount of productive facilities must be released from other employment. It is not enough that technology and know-how is available to create new factories and modern machinery. Investors and businessmen must be willing to accumulate capital by doing the necessary investing. Furthermore, the creation of credit must not be confused with capital accumulation. People see idle factories and wonder why they cannot be used to produce the much-needed goods, with the aid of easier credit, if necessary. They fail to understand that the plants have become obsolete because adequate reserves were not set aside for depreciation and replacement. Or, if it is a new plant, people fail to understand that its construction in the first place was based on a miscalculation due to the false signal of easy credit. Rising costs have made a profitable operation impossible. People find it hard to see the thin edge of the wedge between capital accumulation and capital decumulation.

Capital decumulation, therefore, is the result of government action, such as the departure from the principle of fiscal policy. As the government creates more money and credit through deficit spending, prices and wages rise. Operating costs tend to rise faster than revenues, thus reducing profits. The result is idle factories and idle men. In short, the effect of deficit spending is more of the same condition that it was supposed to eliminate in the first place. Thus a vicious circle is put into place: deficit spending creates idle capacity and unemployment, which then call for more deficit spending, to create still more idle capacity and more unemployment.

Kick the Garbage Upstairs

There are those economists who suggest that the process of deficit spending can continue indefinitely. According to them, the public debt need never be repaid. It can go on growing indefinitely as long as a stable relationship between the debt and the gross national product is maintained. In the Ninth Pillar we shall see why this is a fallacy. Here we may content ourselves with the observation that accumulating debt at the expense of accumulating capital is like dumping garbage in the attic. At one point, the attic is bound to give way and all the garbage will come crashing down.

Chapter 6

The Sixth Pillar of Sound Money and Credit

The Principle of No Privileges Without Responsibilities

A Venetian Tale

Once upon a time, in the fair city of Venice, there ruled a wise and just Doge. He had observed and learned much about his people, about himself and his power. So he let his people go freely about their business, but he granted no privileges without charging the privileged with countervailing responsibilities. One day three men asked for an audience, "Oh great and wise Doge," they cried, "we are sorely troubled and in need of your help." The Doge asked what was troubling them.

"I am a mason," said the first man. "I lay bricks for fine houses. Yet I am idle for the people will not pay my price." The second continued: "I am an artisan. I make many useful artifacts. I use great skill and labor, but the people refuse to pay my wage." The third man stepped forward and said: "And I am a banker. I advance monies I am entrusted with to the mason and to the artisan. But the people won't wait until the mortar sets and the artifacts sell. They demand their money back before my investments come to fruition."

"I can see that your plight is great," said the Doge, and he ordered his attendant to bring forth three swords. "You shall go forth and compel those

who will not deal with you voluntarily to submit to your terms, for the stronger reason of the sword."

"No, no, your Honor," the three men cried, "this we did not ask. We are no highwaymen. We are men of honor. We could not fall upon our fellow countrymen to compel them to our will with the force of the sword. It is you, Oh wise Doge, who must use power on our behalf. Your power is great."

"Perhaps," said the Doge, "perhaps my power is great, but I must use it wisely or else it will be lost." He went on: "You ask me to do what you would not do because of honor." Then he turned to the banker: "Is honor one thing to the banker, and another to the magistrate?" He continued: "My power is a privilege encumbered with grave responsibilities. The charter of your bank confers a great privilege upon you. But your privilege is also encumbered with important responsibilities. You must invest the funds entrusted to you in a manner that they remain accessible to your patrons. You may not sink liquid funds into brick and mortar. You must invest in merchandise that keeps moving."

The Doge dismissed the three men with these words: "I, too, am an honorable man. What is dishonorable to you, will never be less dishonorable to your magistrate."

The Promises Men Live By

At the heart of the irredeemable paper money system of the United States is the fact that the Treasury and the Federal Reserve banks issue promises to pay which they do not redeem, do not intend to redeem, nor have they got the resources to do so. In other words, the Treasury and the Reserve banks have been given the privilege to issue promises and, at the same time, they have been freed from all responsibility to redeem these promises. Both of them wish to keep their favored position.

A vitally important question arises here: On what defensible ground can any institution claim the right to issue promises to pay and at the same time insist that it should not be compelled to redeem those promises? We

have built an intricate legal system in respect to contracts, based upon the elemental and widely-accepted standard of morals, ethics, and common honesty, to the effect that the maker of promises to pay must also assume the corresponding responsibility. We prosecute individuals and institutions when they attempt to avoid the fulfillment of their responsibility.

Harry Scherman, one-time president of the Book-of-the-Month Club, wrote a penetrating book called *The Promises Men Live By*¹. It dealt with some fundamental requisites of satisfactory and honorable social and economic intercourse. He noted that when men's promises cease to be good, trade and production are hampered, credit collapses, people cannot buy, sellers cannot or will not sell, chaos and social degeneration follow, if not immediately nevertheless, inevitably.

Complacency and Connivance

The commercial banks of this country create deposits against their assets, which are payable only in irredeemable currency. As a fraternity, these banks, by their failure to make any concerted effort to end irredeemability have become accomplices of the Treasury and the Federal Reserve banks. There have been a few concerned and upright bankers who fearlessly spoke up against the false and dangerous principle of privilege without responsibility. J. H. Frost, Chairman of the Board, Frost National Bank, San Antonio, Texas, in an address² said, in part: "It would seem that bankers, as the custodians of the people's money, should be more interested than any other class of the population in the maintenance of sound money. Curiously enough, however, the history of most, if not all, of the disastrous inflations of the past indicates that bankers have usually been quite complacent - and often have cooperated in producing monetary inflation. This seems to be largely due to the fact that the liabilities of banks are all monetary and can be discharged by payment in the monetary unit no matter how far

¹N.B.: Harry Scherman, *The Promises Men Live By, A New Approach to Economics*, Random House, New York, 1938.

²*The Commercial and Financial Chronicle*, May 27, 1948.

the depreciation of its purchasing power may have progressed. I believe that, if the bankers of America really understood what was happening to the people's money they would arouse themselves and demand and finally effect a return by this country to a sound currency redeemable in gold."

Holes in the Balance Sheet

It is an arresting and disturbing picture to see the banking fraternity supporting irredeemable currency seeking special privileges for themselves while avoiding the corresponding responsibilities and, as custodians of the people's money, resisting the most basic step that could be taken to terminate the depreciation of the people's money - a restoration of the obligation to redeem promises to pay.

This is not merely a moralistic observation, but a pragmatic one. Redeemable currency used to be the agent ferreting out unsound and uneconomic debt and liquidating it before it had a chance to metastasize. Banks were greatly limited in their power to shelter bad debt in their balance sheets through incompetence or design. Depositors could, by withdrawing the ultimate bank reserve, gold, force the bankers to maintain the highest standards of liquidity and solvency.

Irredeemable currency on the other hand, makes it impossible for the depositors to discipline the erring or dishonest banker. Previously, the depositor could opt out of the banking system altogether by withdrawing and holding gold, if he thought that the banks had become unsafe. By contrast, all he can do under the regime of irredeemable currency is to move his funds from one unsafe bank to another which momentarily appears less unsafe.

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The Ten Pillars of Sound Money and Credit

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Chapter 7

The Seventh Pillar of Sound Money and Credit

The Principle of Liquidity

A Venetian Tale

Once upon a time, a wealthy merchant died in Venice. He was survived by his widow and three sons. His will listed a fortune consisting of 1000 gold ducats: and a wheat farm, a flour mill (both in Lombardy), and a bakery in Venice, each worth 1000 ducats. The old man's will ordered his whole fortune, worth 4000 ducats, to be divided equally among the four survivors. Another clause required that, in case of any disagreement between the survivors, the farm, the mill, and the bakery should be sold and the proceeds divided equally.

The eldest son wanted the farm, the middle son the mill, the youngest son the bakery while the widow was satisfied to have the gold.

The trouble was that no one knew where to find the gold mentioned in the will. Venice was full of the news that a spectacular lawsuit was in the offing, each survivor suing every other for embezzlement.

The Doge was a wise old man, who did not want to hear the survivors accuse each other. So when they appeared before him and sued for justice, he asked the eldest son what kind of crop he expected to bring in. "At least 2000 bushels," was the answer. The Doge turned to the middle son and asked how much flour

would 2000 bushels of wheat grind into. “At least 80,000 pounds,” answered the middle son. Then the Doge asked the youngest son how much bread he can sell out of 80,000 pounds of flour. “At least 1000 ducats’ worth,” the youngest son answered.

At this point the Doge turned to the widow and said to her: “There is your 1000 gold ducats. You just have to help each other until the wheat matures into flour, the flour matures into bread, and the bread matures into gold.”

As the Doge dismissed them, he said to the three sons: “According to the proverb, not all that glitters is gold. Your late father has now shared with you the last measure of his wisdom, which is this: A lot of things don’t glitter at all, yet they may be well on their way to ripening into gold in your busy hands.”

Self-liquidating Paper

Just as wheat ripens into gold by the time the flour is baked into bread, so does every other merchandise, at the time it is offered for sale to the ultimate cash-paying customer. We may express this ripening process by saying that, as the semi-finished goods become finished goods, they also become ‘liquid’.

When a commercial bank makes a loan to a producer or distributor, the commercial paper that arises becomes the bank’s asset. Commercial paper is considered liquid, if the underlying merchandise is liquid. Such paper is also called ‘self-liquidating’, because at the time the merchandise ripens into gold, the gold coin of the consumer will liquidate the loan.

By contrast, a loan to finance the construction of a building is not liquid, let alone self-liquidating, because it may take decades before the brick and mortar sunk into the building can amortize the construction costs. Further by contrast, a loan for carrying a speculative storage of goods is not liquid, because the goods are not moving, and they won’t be sold before the bank loan matures. The financing of such slowly maturing projects should not be in the purview of the commercial banks; they should be left to the

investment bank which uses actual savings for the purpose, as we shall see in the Eighth Pillar.

Propensity to Consume

Commercial banks do not depend on saved funds for their operation, as do investment banks. They finance trade by relying on the liquidity of maturing merchandise. Commercial paper can and does circulate in the sense that a second bank will always be glad to acquire it as an earning asset if the first bank needs cash in a hurry.

Commercial paper is an earning asset because it is bought and sold at a discount below face value, the amount of discount being proportional with the number of days to maturity. The discount rate is inversely related to the “propensity to consume”: the greater this propensity the lower is the discount rate, and vice versa. The commercial bank derives its profits from the fact that, while it has earning assets, it usually pays no return to its creditors on the corresponding liabilities (called bank deposits).

To summarize, whereas investment banking relies on the propensity of the people to save, commercial banking relies for its operation on the propensity of the people to consume. It is the propensity to consume that puts consumer goods on the move and makes commercial paper representing them liquid.

The highest quality commercial paper matures in 91 days or less. That time is just the length of the seasons, and consumer demand and consumption patterns do change with the seasons. If a certain type of merchandise cannot be sold in less than 91 days, then it cannot be sold for another 365 days, before the same season of the year comes around once again.

The Principle of Liquidity asserts that the earning assets of the commercial banks must consist of self-liquidating paper drawn on consumer goods moving from the producers to the market, which will be sold to the ultimate cash-paying consumer in 91 days’ time or sooner. Commercial banks must keep away from finance paper, or commercial paper drawn on slowly

moving merchandise, mortgages, stocks, bonds. etc. None of these has the liquidity to be eligible as an asset in the portfolio of commercial banks.

The Real Bills Doctrine

As long as the commercial banks respect the Principle of Liquidity, they can't get into trouble, nor can the banking system as a whole. Should an individual bank experience unusually heavy cash withdrawals, it would find a ready market for its earning assets because other banks with excess cash would be happy to buy liquid assets. If the banking system as a whole experiences unusually heavy cash withdrawals, this can also be met without difficulty as the assets of the banking system get more liquid with the passing of every day and at least one-ninetieth of those assets mature into gold on each and every business day. The only scenario which would embarrass the commercial banks is the one in which the people stopped consuming altogether - but this is too far-fetched for serious consideration. Trouble only comes if banks yield to temptation, and get involved with slow paper.

We owe the Principle of Liquidity to the great 18th century Scottish thinker, the father of classical economics, Adam Smith. He was the first who expounded the "real bills doctrine," as this principle is also known, in his book, *The Wealth of Nations*. He noticed that before the Bank of England opened a branch office in Manchester, commercial paper drawn on the rapidly moving merchandise in Lancashire circulated very much as banknotes would, under their own steam and on their own wings. They did circulate, because their liquidity was the highest, second only to that of the gold coin.

There is no way to make stocks, bonds, and mortgages to circulate on the pattern of the circulation of commercial paper, for lack of sufficient liquidity.

The banking system in the United States is not just illiquid, but is in an advanced state of petrification. Only a small part of bank assets could be liquidated on short notice without great losses. The commercial banks rely

The Ten Pillars of Sound Money and Credit

on the Federal Reserve to replenish their reserves daily, rain or shine. The assets of the Federal Reserve banks are not much better: they consist of government securities. In case of a run, the Federal Reserve would be in no position to meet the demand for cash through honest asset-liquidation, because it would break the bond market. The Fed would have to monetize the bad assets of the commercial banks, which would make its own position even less liquid. Therein lies a great danger.

We may have to pay a high price for our contemptuous disregard for the Principle of Liquidity.

Chapter 8

The Eighth Pillar of Sound Money and Credit

The Principle of Matching Maturities

A Venetian Tale

A Venetian merchant lost his ship of cargo on the reefs of the Dalmatian coast. As he was sitting in a cove lamenting his loss, a mermaid appeared and inquired what was the matter. Feeling sorry for the merchant who lost his entire fortune in the accident, she dived into the sea and brought up a boat laden with silver, and asked him if that were the boat he had lost. When the man said that it wasn't, the mermaid dived again and fetched up the merchant's own boat. "That's the right one," he said gratefully. The mermaid, so delighted with his honesty made him a present of the other boat as well.

When he returned to Venice and told his colleagues about his good fortune, one of them thought that he could pull off a similar coup. He loaded his boat with merchandise, sailed to the Dalmatian coast and scuttled his ship. Then he sat down in the cove and wept. The mermaid appeared again. Upon hearing the cause of his tears, she dived and soon produced a boat laden with gold asking if it were the same one that had been lost. The man, who has never seen that much gold in his life, cried ecstatically: "oh yes, indeed!"

The mermaid was so shocked at this unblushing impudence that, far from giving him the boat with its gold cargo, she did not even restore his own to

him. “You are not only a liar,” she said, “but also an impostor.” She sailed away leaving the man alone in the deserted cove.

The Propensity to Save

As we have seen in the Seventh Pillar, there is a significant difference between commercial banking and investment banking (including savings banks). The former depends on the people’s propensity to consume, and the latter, on their propensity to save. The banks pool the flow of savings from individuals, and make this pool feed the flow of investments to every part of the national economy. The banks borrow funds from the savers for various fixed terms, and lend them out to producers, entrepreneurs, speculators, for various fixed terms. The banks have a double balancing act; they must balance their liabilities with assets not only dollar for dollar, but also maturity for maturity. That is to say the banks must see to it that their assets mature no later than their liabilities. This is known as the *Principle of Matching Maturities*.

Since there is no investment without prior saving, the minimal rate of interest is determined by the propensity to save (or by its reciprocal, time preference). The higher the propensity to save, the lower is the minimal rate of interest (or, the lower the time preference, the lower is the minimal rate of interest) and conversely.

Borrowing Short and Lending Long

The Principle of Matching Maturities is often quoted in its negative form: a bank must not borrow short and lend long. This is the one commandment most often violated by the banking fraternity. To understand the underlying temptation, we have to examine the source of bank profits. The investment bank derives its profits from the spread between the interest it earns on its assets and the interest it pays on its liabilities. The bank could, illegitimately,

increase its profits by borrowing short at an even lower rate, and lend long at an even higher rate because longer term borrowing and lending normally command higher interest rates. The bank guilty of this illegitimate practice is an impostor, as it misrepresents the true state of affairs in the balance sheet, just as the greedy Venetian sailor misrepresented his situation to the mermaid.

The practice of borrowing short and lending long is no less dangerous than it is illegitimate. The bank would obviously have to borrow again and again, before its assets matured. No one knows the future, and the bank is no exception. Future borrowing conditions may be worse than those at present. The bank may be confronted with borrowing costs higher than the earnings it has locked itself into or, in an extreme case, the bank may not be able to borrow at any price.

A bank guilty of borrowing short and lending long is not only an impostor but a liar as well. It lies in overstating the value of its assets and understating its liabilities in the balance sheet. The bank in fact pretends that it can use short term funds to balance its long term liabilities.

Short Debt Makes Long Friends

The American banking system is in deep trouble on account of its long-standing addiction to the drug of borrowing short and lending long. Worst offenders are the savings banks loaded with mortgages maturing in 20 years or longer, held against liabilities maturing daily. That this situation is preposterous should be clear to every impartial observer. The bank has sunk liquid funds into brick and mortar, against which it holds liabilities subject to withdrawal without notice (or on short notice). The banks are sitting on mountains of paper losses, which will become real losses at the first test of extensive cash withdrawals.

Federal deposit insurance is hardly a fig leaf. The assets of the insurer cover only a minuscule part of its contingent liabilities. Worse still, these

assets are carried in the form of government securities, and even a minor asset liquidation would embarrass the government and break the market.

Had the American banks taken to heart the ancient wisdom of the English proverb: “short debt makes long friends.” They could have avoided diverting enormous resources into loan-loss reserves.

Vicious Circle

If bank liabilities mature faster than bank assets, then two things will happen. (1) Interest rates will rise, as the banks are forced to resort to asset-liquidation, and the public will acquire these assets only at a concession in price. (2) The maturity structure of the debt will shrink, as the banks are forced to issue short-term debt in exchange for long-term debt. In other words, the banking system, led by the central bank, is forced to finance a massive exodus of the savers from long to short term debt. As the banking system has to absorb more and more long-term debt, unwanted by the saving public, and give short-term credit in exchange, it becomes clear that the only cure for the condition caused by that drug abuse is more drug abuse.

The central bank is helpless. Any hesitation on its part to make available the reserves needed to meet the maturing liabilities of banks would bring down the house of cards immediately. The central bank would therefore continue to buy the long-term bonds dumped by a disgruntled public. That is to say the central bank would continue to borrow short and lend long on an ever larger scale.

The vicious circle, however, cannot continue indefinitely as the average maturity of the debt cannot shrink to zero. Before that happens the bond market, like a rotten apple, will fall into the lap of the money market. The money supply will explode, the supply of savings will implode, and the new brave world of borrowing short and lending long will come to a sorry end.

Chapter 9

The Ninth Pillar of Sound Money and Credit

The Principle of Productivity of Debt

A Venetian Tale

Once upon a time a poor gondolier of Venice, having done a favor to the gnomes of the Piazza, was given a magic pepper mill that would grind out anything at a word. The gondolier, a modest man, used it only to keep flour and sugar in supply. But his brother, a wealthy salt merchant, upon learning of the mill, cajoled its secret word from the gondolier, stole the mill by night, and set out to sea for the markets in the Levant.

Eager to try his prize and fill his sacks he uttered the word, and the mill began to grind out salt. The vessel's holds were soon filled and salt began to cover the deck. The merchant now tried to stop the mill, but alas, he had forgotten to learn the other secret word. The ship began to settle, and finally sank, carrying with it the avaricious merchant along with the mill, where it still rests, at the bottom of the sea, grinding out salt.

And that, the tale concludes, is the reason why the sea is salty.

Debt Mill on the Potomac

Most observers worry about the inordinate growth of the money supply. But the growth of the money supply is merely a symptom, concealing a far more serious condition: *the uncontrollable growth of dollar-denominated debt*. The magic mill of the Venetian gondolier has been commandeered by the masters of the Federal Reserve System. They uttered the word, and enjoyed the sight of the uninhibited outpourings of cheap credit. But the obverse of credit is debt, and the mill on the Potomac River started flooding the country with bad debt that can never be repaid. The new masters of the mill would like to stop it, but alas, they have forgotten to learn the other word. The nation's economy, overburdened with bad debt, has started sinking.

In Praise of Debt

Debt is not bad *per se*. Debt embodies the symbiosis between the three progressive classes of people in the economy: the savers, the producers, and the inventors. Debt is the instrument facilitating the exchange of the wealth of the savers for income. Debt is the instrument facilitating the acquisition of state-of-the-art technology by the producers, in order that they may get the highest output per input of labor and capital for the benefit of everybody. Debt is the instrument facilitating the exchange of the future wealth of inventors for present income in support of research and development. Debt alone can make possible the extension of division of labor to generations that are far removed in time. Debt alone makes the emancipation of savings possible: saving is no longer anti-social as it was when the saving of a gold coin perforce meant a contraction of demand, prices, and output. Through debt as catalyst, saving is more beneficial than spending: the present wealth and income of savers find their way to the producers and inventors, and to the socially most beneficial applications.

The Danger of a Debt Meltdown

Debt, however, is not without its dangers. It is not unlike nuclear energy. It can be enormously beneficial if properly harnessed and constrained - but it can also be equally destructive if the harness and constraint are removed. Bad debt is like fissionable matter. It can keep accumulating unobtrusively and without any apparent bad effects up to a point. But once this critical point is reached, a meltdown occurs. Proper safeguards in debt creation are therefore imperative.

The distinction between good and bad debt is not subjective or arbitrary. The quality of debt can be gauged by its productivity. This is the ratio of the net gain in GNP (gross national product) to the gain in debt. (The net gain in GNP is the excess of additional GNP over additional debt.) If this ratio is positive, then the new debt can be serviced out of current income, and the greater the ratio, the higher is the quality of debt. If the productivity of debt is allowed to decline significantly or, worse still, to become negative, then the debt can no longer be serviced out of income, and new debts have to be incurred to meet the maturing debt. The negative ratio is a clear signal that bad debt is now breeding more bad debt. A feedback is in effect, short-circuiting the economic process. The debt-tower is growing out of control, and in due course it will self-destruct.

Debt Accumulation versus Capital Accumulation

The Principle of Productivity of Debt asserts that the ratio of net gain in GNP to the gain in debt must never be allowed to become negative. If this principle is observed, then debt is properly harnessed and constrained, and is socially beneficial. It makes a positive contribution to economic growth and public welfare.

We have long since passed the point when debt had a positive productivity in this country. Before 1960 it took less than one dollar of new debt to produce \$1 gain in GNP. But in the 1960's, on average, it took \$2. In the

1970's it took \$5, and in the 1980's so far. It's taken \$3.50 of new debt to produce the same \$1 gain in GNP. The growth of bad debt is accelerating.

It should be clear that this trend cannot continue indefinitely. The new debt has no economic justification. It does not produce the income to amortize itself, let alone a spendable income. Sooner or later the fantastic debt tower will topple, and bury the economy that prefers debt accumulation to capital accumulation.

We Owe It to Ourselves

There are those economists who maintain that the public debt is just the other side of public investment and therefore its growth, far from alarming, is actually beneficial. The public debt need never be repaid. "We owe it to ourselves," they say pointing out that if a family goes bankrupt, it is never on account of internal family debts, but on account of debt owing to outsiders.

There has never been a more vicious misrepresentation of economic fact. The public debt is being serviced at the expense of the taxpayers, and if it will never be retired, then taxation can only grow worse. Moreover, the credit worthiness of the government can suddenly evaporate, if creditors lose all faith in the ability of the government to consolidate and eventually to retire the public debt.

Debt in the United States is presently (1985) increasing at the annual rate of 14%. Most of this inordinate increase can be accounted for by the high rate of interest, far in excess of the productivity of labor and capital. Interest payable on the debt must be created out of nothing, to keep the game of musical chairs moving. But the merry-go-round must stop sooner or later. The solution to the problem of debt is to bring down the rate of interest at once to the level of the productivity of labor and capital in this country. That part of the debt that can be serviced at the lower interest rate will be consolidated; the rest must be written off. Then creditors in the future will

The Ten Pillars of Sound Money and Credit

think twice before they lend to the government and businesses which bank on new credits to meet interest payments on old debts.

Chapter 10

The Tenth Pillar of Sound Money and Credit

The Principle of Productivity of Labor and Capital

*A Venetian Tale*¹

Once upon a time a man by the name Shylock was the Public Treasurer in the prosperous city of Venice. The finances of the city state deteriorated grievously under his stewardship. Foreign entanglements and the mindless substitution of public largesse for private charity were to blame for the sorry state of the public purse. Shylock issued Treasury bonds supposedly paying interest at the usurious rate of 15 percent, not bothering to ask how payments of principal and interest, when they fall due, would be met.

Before he became Treasurer, Shylock was a heartless usurer on the Rialto, where other merchants, in particular one by the name of Antonio, openly reproached him for his covetousness. Thus there was great enmity between the two men and, although Shylock would bear the scorn with seeming sufferance, he secretly meditated revenge. His chance came when the combination of high tax and interest rates forced Antonio's business into receivership, and himself into the debtor's jail.

When the day of his trial arrived, Antonio's counselor, an unknown young lady doctor by the name Portia appeared before the Duke and his senators,

¹(Adapted from: *Tales from Shakespeare*, by Charles and Mary Lamb, London, 1807.)

while the Treasury was represented by Shylock himself. With the Duke's permission, Portia started the proceedings by addressing herself to Shylock. Admitting at once that he had the right, by the laws of Venice, to deprive Antonio of his property and personal freedom, she spoke sweetly of the noble virtue of mercy and how tax-forgiving was a double blessing, as it blessed the state that gained a future taxpayer, and the taxpayer that gained a chance to reorganize his business. But neither her reason nor her passionate pleas softened the heart of Shylock, who reiterated his demand for selling Antonio into servitude.

Portia gravely responded that the law once established, must not be bent. Hearing this, Shylock exclaimed: "oh learned and upright judge, I honor thee! A Daniel is come to judgment! Prepare, Antonio: we must not trifle time."

"Wait," said Portia, "before you sell Antonio into servitude, you must understand that his price shall cover not only his past but also his future tax liabilities. Otherwise you shall personally assume the burden." Hearing this, Antonio's friends in the audience cried out: "oh wise and upright judge! Mark the word, Shylock, a Daniel is come to judgment!"

Shylock, who would not for a moment think of assuming the future tax liabilities of Antonio under the tax laws of Venice which he himself fashioned for the discomfort of his rival, conceded defeat, saying: "Let me go in peace."

"Not so fast," said Portia. "The laws of Venice protect her taxpayers against conspiracy and vindictive use of high public office. In driving up tax and interest rates to heights unheard of in the history of this city, you have attempted to exact a pound of flesh from every honest merchant of Venice. I plead with the Duke to deprive you of your high office as an exemplary punishment, for the edification of future generations."

The Duke, after considering the evidence, gave Shylock a dishonorable discharge from his duties as Public Treasurer. The tax and interest rates in Venice soon returned to a low and stable level. Labor and capital were no longer crucified on the cross of the public debt. Venice continued to prosper. And even today jurisprudence talks about the Shylock doctrine, when it refers to the natural law forbidding the exaction of payment for debt from a debtor in excess of the productivity of labor and capital.

The Marginal Worker

The pupils in a classroom can be ranked according to academic achievement, as measured by their marks. If the passing mark is 50%, then the marginal student is the one with the lowest mark above 50%; any student with a lower mark is sub-marginal. If the teacher now changes the passing mark from 50% to, say 65%, then this change would render a number of additional students submarginal, even though there was no deterioration of industry or aptitude on the part of these students.

The situation in the national economy is entirely analogous. Labor and capital can be ranked according to productivity. The worker with the lowest productivity rating above the rate of interest is called the marginal worker (and his tools, the marginal capital). Workers whose productivity ranks below that of the marginal worker, are sub-marginal. They are earmarked to be laid off as soon as their tools, the sub-marginal capital, will complete their amortization cycle. Indeed, no prospective employer would hire a sub-marginal worker if he could invest his funds and earn interest at a rate in excess of the rate of productivity of sub-marginal labor.

If the rate of interest goes up, there is an immediate effect of rendering additional labor and capital sub-marginal, regardless of whether or not the productivity of individual laborers has declined. Thus we see that the maximum rate of interest determines the marginal productivity of labor and capital. It arbitrarily decides who can keep his job and who shall lose it, which capital equipment can stay in production, and which shall be doomed to the sub-marginal scrap-yard. The Principle of Productivity of Labor and Capital asserts that the maximum rate of interest must be low enough to allow all those, who are eager to earn wages, to find employment; and also low enough to allow new capital goods to begin their amortization cycle.

Depreciation Premium

The carefully concealed truth is that interest rates are high today (1985) because they incorporate a large depreciation premium, designed to compensate the lenders of funds for loss of purchasing power due to the depreciation of the dollar. In fact, all regimes of irredeemable currency in history have pushed interest rates into outer space, as these currencies succumbed to their inevitable fate of accelerating depreciation. And as the rate of interest rose, so did unemployment widen; so did the destruction of capital spread.

Class War

One of the most powerful arguments in favor of a gold standard is that it alone can make the marginal productivity of labor and capital low enough, so that all those eager to earn wages can find gainful employment, and so that capital will be accumulated and adequately maintained. No sooner is the gold standard removed than the Shylock syndrome will appear, rendering a large part of the labor force and a large part of the capital park of the country sub-marginal, and hence, unemployed. As the workers and the owners of capital goods are pitted against the lenders, social harmony and cooperation gives way to class war and social unrest. The only solution is the resumption of a gold standard. There are two ways to resume; targeting prices, and targeting interest. Targeting prices aims at a price level prevailing before suspension, and it involves *increasing* the metallic content of the monetary unit, while leaving interest rates alone. By contrast, targeting interest aims at a level of interest rates prevailing before suspension, and it involves *decreasing* the metallic content of the monetary unit, while leaving prices alone.

Solon's Seisachthea

Historically most resumptions were of the first type, causing economic contraction characterized by declining prices accompanied by declining interest rates. As a result, many observers concluded that the gold standard was deflation-prone.

The fact, however, is that there need not be any painful deflation, if the second type of resumption is carried out. Prices should be left alone, while interest rates are reduced overnight. This is what one of the greatest social reformers of all times, Solon (640-559 B.C.), Athenian law-giver, merchant and poet accomplished with his Seisachthea (in literal translation, disen-cumbrance). According to the historian Plutarch, he lowered the metallic content of the monetary unit, the drachma, to 73% of the original, and simultaneously reduced the rate of interest on the outstanding debt by law. There was great relief across the land, and Solon recorded his own deed in verse as follows:

*"The mortgage stones that covered her, by me
Removed: the land, that was a slave, is free ...
...Such power I gave the people as might do.
Abridged not what they had, nor lavished new:
Those that were great in wealth and high in place
My counsel likewise kept from all disgrace.
Before them both I held the shield of might.
And let not either touch the other's right."
(The Dryden translation)*
